MCI

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FEDERAL COMMUNICATIONS COMMISSION
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January 10, 1994

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Mr. William F. Caton
Secretary
Federal Communications Commission
1919 M Street, NW, Room 222
Washington, DC 20554

Re: CC Docket No. 93-251 - Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and their Nonregulated Affiliates

Dear Mr. Caton:

Enclosed herewith for filing are the original and four (4) copies of MCI Telecommunications Corporation's Reply Comments in the above-captioned proceeding.

Please acknowledge receipt by affixing an appropriate notation on the copy of the MCI Reply Comments furnished for such purpose and remit same to the bearer.

Sincerely yours,

Elizabeth Dickerson

Elizabeth Dickerson
Manager, Federal Regulatory

Enclosure
ED/ms

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

ORIGINAL

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20054

In the Matter of	)	
	)	
Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates	)	CC Docket No. 93-251

REPLY COMMENTS OF MCI TELECOMMUNICATIONS CORPORATION

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SUMMARY

In response to LEC arguments that existing regulations such as price caps and the existence of competition render the proposed affiliate transaction rules unnecessary, MCI argues that current industry conditions indeed support adoption of strengthened rules. Although the Commission has not identified specific LEC transgressions as the rationale supporting its proposed rules, the Administrative Procedure Act does not require such a showing. LEC estimates of the administrative costs and burdens associated with the Commission's proposal are overstated and unsubstantiated, and the LECs ignore the benefits of the rules. The Commission should adopt its proposed 75% bright line test for allowing carriers to rely on prevailing company pricing standards. It should extend fair market valuation requirements to services. Finally, the Commission should limit the authorized rate of return for non-regulated services and products provided to regulated operations to the lowest point of the authorized return range allowed for each variety of regulation in effect.

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OFFICE OF THE SECRETARY

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In the Matter of	)	
	)	
Amendment of Parts 32 and 64 of	)	
the Commission's Rules to Account	)	CC Docket No. 93-251
for Transactions between Carriers	)	
and Their Nonregulated Affiliates	)	

REPLY COMMENTS

MCI Telecommunications Corporation ("MCI") hereby submits its reply comments in response to comments filed on December 10, 1993, in the above-captioned proceeding. In its initial comments, MCI argued that the FCC's present mix of affiliate transaction valuation methods falls short of protecting ratepayers against cross-subsidization, and MCI supported adoption of the rules the Commission proposes. MCI believes that the current reliance on prevailing company pricing should be discontinued, except in the limited circumstances the Commission delineates (when the carrier meets a test showing its primary purpose is not to supply its regulated affiliate). Further, MCI supports the rate base methodology the Commission contemplates, except that the rate of return should be calculated at the low end of any ranges the Commission's alternative regulatory schemes provide. MCI also favors the Commission's proposed change in the valuation methodology for services (at the lower of cost or fair market value ("FMV") for those provided to the BOC regulated entity and at the higher of cost or FMV for those the regulated entity provides). Finally, MCI believes that any underlying cost changes resulting from modifications to valuation methodologies should be afforded exogenous treatment, and the Cost Allocation Manuals and audit procedures should be modified to accommodate these rule changes.

I. Introduction

Generally, comments were limited to the Bell Operating Companies and larger independent local exchange carriers ("LECs"). As MCI anticipated, they vehemently opposed the Commission's proposed rule changes, and indeed, they argue that developments in the industry since the Commission reaffirmed its affiliate transaction rules[1] support less stringent -- rather than more strict -- modifications to the rules.[2] Specifically, they contend that the proliferation of competition within the industry and the adoption of price cap regulation eliminate any incentives the LECs would have to cross-subsidize their non-regulated businesses with profits from their regulated operations.[3] They argue that the proposed rules are contrary to the Commission's goals of

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[1] Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier 1 Local Exchange Company Safeguards, CC Docket No. 90-623, Report and Order, 6 FCC Rcd 7571, para. 12 (1991).

[2] See, e.g., Comments of BellSouth, p. 5; Comments of NYNEX, p. 2; Comments of Pacific Telesis, p. 6; and Comments of Southwestern Bell, p. 2.

[3] See, e.g., Comments of Bell Atlantic, p. 3; Comments of GTE, p. 4; Comments of Pacific Telesis, p. 4; and Comments of the United States Telephone Association ("USTA"), p. 2.

procompetitive and streamlined regulatory policies.[4] Further, the LECs submit that the Commission has failed to enumerate even a single example of a carrier transgression of the current rules that might support strengthening the current rules,[5] and its proposed rules are contrary to the Commission's procompetitive and streamlined regulatory policies.[6] Finally, they contend, the Commission has failed to identify any benefits to be derived from the rule changes that could justify the exorbitant additional administrative burden and costs that adoption of the rules would generate.[7]

Specifically, the LECs argue for rejection of the Commission's proposed 75 percent "bright line" test to determine whether the product or service qualifies for prevailing company price treatment. They also urge the Commission to reject its contemplated extension of fair market valuation of services provided to or by nonregulated affiliates.

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[4] Comments of Ameritech, p. 7; Comments of Bell Atlantic, p. 3; and Comments of BellSouth, p. 20.

[5] Comments of BellSouth, p. 4; Comments of NYNEX, p. 14; and Comments of Southwestern Bell, p. 1.

[6] Comments of ALLTEL, p. 2; Comments of Bell Atlantic, p. 2; and Comments of BellSouth, p. 18.

[7] Comments of ALLTEL, p. 2; Comments of Ameritech, p. 12; Comments of BellSouth, p. 20; Comments of Cincinnati Bell Telephone ("CBT"), p. 1; and Comments of GTE, p. 12.

II. Current Industry Conditions Support Adoption of Strengthened Affiliate Transaction Rules.

The LECs argue that changes in the telecommunications industry have created an environment that no longer requires the type of protection from the risk of cross-subsidization that even the current affiliate transaction rules provide. Bell Atlantic contends that "the proposed rules are out of step with today's telecommunication's environment," where carriers have no incentive to either "subsidize their nonregulated affiliates" or "to increase their costs."[8] Similarly, NYNEX believes that the Commission's proposals "are unwarranted in light of dramatic changes in the telecommunications environment which have significantly lessened any incentive or ability of carriers to shift costs to telephone ratepayers.[9] Specifically, the carriers contend that the proposed modifications to the affiliate transaction rules are unnecessary given the current level of increased competition that serves as a disincentive for carriers to overprice regulated products and services.[10] Also, they point to price cap regulation itself as a mechanism that "eliminates" the incentive to engage in cross-subsidization.[11]

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[8] Comments of Bell Atlantic, pp. 4, 5.

[9] Comments of NYNEX, p. 2.

[10] See, e.g., Comments of Pacific Telesis, p. 2; and Comments of USTA, p. 2.

[11] See, e.g., Comments of Bell Atlantic, p. 4; and Comments of NYNEX, p. 10.

Not only is there virtually no local exchange competition, but the current price cap regime does not eliminate carriers' incentives to cross-subsidize services not subject to price caps with services that are. Until effective competition exists, strict affiliate transaction rules must be adopted and maintained in order to ensure both that competition can develop and that the regulated ratepayers do not suffer financial harm at the expense of a carrier's non-regulated endeavors.

A. Until Effective Competition Develops, the Commission Must Continue to Impose Regulation that Protects Ratepayers and Encourages the Development of Competition.

GTE boldly announces that "[t]he reality of exchange competition has been well and thoroughly demonstrated."[12] It cites significant increases in "competitive risk at the local loop," the success of the competitive access providers in having "taken substantial shares of the markets they have targeted," the "extensive alliances and/or mergers between cable companies and caps," the penetration of cable networks, and the wide availability of cellular services and the planned personal communication service.[13] Other commenting parties more realistically recognize that technologies are "emerging,"[14] and competition is "increasing."[15] The major competitive

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[12] Comments of GTE, p. 4.

[13] Id., pp. 4-6 (emphasis supplied).

[14] Comments of USTA, p. 12.

[15] Id.; and Comments of Pacific Telesis, p. 3.

initiatives that the LECs cite have neither been approved by the necessary regulatory and security agencies, nor, in most cases, have the deals been consummated.[16] LECs have failed to offer any evidence that, in the relevant markets, competition is effective to the degree that would warrant elimination of those rules that protect current ratepayers and foster a competitive environment. This is simply because competition in these markets is in its infancy, and regulations must reflect current conditions, not planned or anticipated market occurrences.

Further, NYNEX's statement that "Interexchange carriers ... also offer a competitive alternative to the NYNEX network"[17] absurdly misstates the state of competitive access. While competition may develop at different rates in different markets, the specific market under consideration in the instant proceeding is interstate access, for which there are very limited and currently insignificant alternatives to the LECs' services. In fact, MCI currently purchases over 99% of its interstate access from LECs; the residual 0.06% competitive access cannot be characterized as "substantial" competition under any definition. Until such time as effective competition exists, regulations such as those now proposed by the Commission are necessary to ensure that a level

[16] MCI's announcement on January 4, 1994, that it intends to offer competitive access in twenty metropolitan areas represents future, potentially effective competition, and virtually has no bearing on the state of competition in the market today.

[17] Comments of NYNEX, p. 8.

playing field exists on which effective competition actually can develop. That is, until effective competition for interstate access exists -- and it does not -- affiliate transaction rules must be fashioned to discourage attempts to cross-subsidize that arise naturally in an environment where a company's different lines of business are subject to different degrees of regulation, risk, and earnings potential.

B. So Long as the Price Regulation that Governs the LECs Contains a Sharing Mechanism, the Commission's Rules Must Reflect that Current Reality.

Nor does the price cap regulation eliminate carriers' incentives to engage in cross-subsidization. Contrary to NYNEX's allegation that "[t]he FCC has acknowledged that price caps eliminate the motivation to cross subsidize non-regulated operations,"[18] the FCC has stated that incentives to cross subsidize continue even in the absence of a sharing mechanism since earnings remain a key measure of performance in a price cap system. Moreover, the Commission previously rejected LEC arguments that regulatory controls on cost allocations between regulated and nonregulated operations are not necessary in a price cap system.[19] As long as the opportunity and the incentive to engage in cross-subsidization exists, it is appropriate for the Commission to

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[18] Comments of NYNEX, p. 10 (emphasis added).

[19] In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, released October 4, 1990, para. 397.

adopt rules -- such as those proposed in the instant proceeding -- that minimize the risk that the LECs will indeed engage in such behavior.

Many carriers argue that if it is the sharing mechanism that serves to retain the incentive to cross subsidize,[20] contemplation of the proposed modifications to the affiliate transaction rules should be postponed until the Commission's 1994 price cap review has been completed.[21] The proposed rule changes, however, must be considered on the basis of existing rules -- not on the basis of speculation about what future actions the Commission may take. The LECs' underlying presumption that the sharing mechanism will be eliminated at the conclusion of the price cap review is founded on pure speculation. There is no sunset provision ensures the elimination of the sharing mechanism at the end of the four year initial price cap period. Indeed, the sharing mechanism is part of the current law that regulates LECs and it is inappropriate to settle current issues on the basis of anything other than today's environment. Just as Southwestern Bell [incorrectly] admonishes the Commission for basing its rationale for the NPRM on "nothing more than idle

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[20] Carriers subject to price cap regulation can manipulate their earnings levels by increasing or decreasing their costs to their advantage. A carrier may forestall or eliminate its sharing obligation altogether by acquiring services and products from a nonregulated affiliate at an inflated level (while the overall corporation benefits from increased profits). Conversely, a carrier who is earning at the low level of the authorized range may similarly inflate its costs in an effort to stimulate the lower adjustment formula mechanism.

[21] See, e.g., Comments of Bell Atlantic, p. 7; and Comments of US West, p. 5.

speculation and 'what-ifs',"[22] MCI suggests that the appropriate body of rules to consider is the one that currently is in existence, and it is imprudent to delay the adoption of necessary rules on the basis of the LECs' preference for a specific, but not guaranteed, outcome.

III. The Administrative Procedures Act Does Not Require the Commission to Enumerate Past Carrier Transgressions as a Basis for a Proposed Rule Change.

The LECs virtually unanimously argue that the Commission has not offered any rational basis for its proposed rule changes, and as such, should not adopt them. Bell Atlantic notes that the Commission "provides not a single example of a transaction over those six years which harmed the public."[23] The Southern New England Telephone Company ("SNET") remarks that "[n]o evidence suggests that consumers have been or will be harmed under the present rules, or how carriers have been imprudent."[24] Even the International Communications Association ("ICA") that argues that the proposed reforms are "absolutely necessary" asks that the Commission "specify with greater particularity the bases for its conclusions."[25]

Such remarks, however, both presume a level of obligation for the Commission that simply does not exist and overlook the very nature of

[22] Comments of Southwestern Bell, p. 3.

[23] Comments of Bell Atlantic, p. 9.

[24] Comments of SNET, p. 2.

[25] Comments of ICA, p. 7.

accounting rule transgressions. First of all, there clearly is no requirement in the Administrative Procedure Act that the Commission must establish as its basis for a proposed rulemaking, a history of carrier abuses in order to change the rules. To the contrary, all that the Commission must do is offer a reasoned explanation as to the basis for its proposed changes.[26] Here, the Commission has taken a common sense approach to resolving a potential problem. It notes that its six years experience with the current valuation methods "has let [it] analyze the bases for and practical effects of the present methods in far greater detail than was possible prior to their adoption."[27] During this time the Commission has implemented and continues to fine-tune its Automated Reporting Management Information System ("ARMIS"), allowing it to more accurately scrutinize the accounting data the LECs submit. While not offering specific examples, the Commission states that its belief that the current methods are "less than optimal" has derived from its analysis of ARMIS data.[28]

In addition, the nature of carriers' cost allocation and affiliate transaction audits is such that the Commission often must treat that information on a proprietary basis, e.g., through a consent decree that keeps the alleged violations of Commission rules out of the public record. The Commission,

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[26] 5 USC § 553(c) (agency shall provide a concise statement of basis and purpose of the rules). See, Greater Boston Television Corp. v. FCC, 444 F.2d 841, 8952 (D.C.Cir. 1970), cert. denied, 403 U.S. 923 (1971).

[27] NPRM, at para. 9.

[28] Id., at para. 10.

therefore, does not identify specific carrier abuses because -- much to MCI's chagrin -- the LECs are sheltered from the publicity through proprietary agreements or other arrangements that prevent such information from being generally available to the public. As ICA points out, major FCC audit determinations, such as those involving NYNEX Material Enterprises in 1990, or the recent findings involving transfers between BellSouth Services and its affiliated operating telephone companies, have been based upon "data that is not disclosed to the public."[29] It is disingenuous, therefore, for the LECs to point their fingers at the very provisions under which they seek safe haven.

IV. The LEC Estimates of Administrative Costs and Burdens Are Overstated and Unsubstantiated, and Benefits of the Rules Are Ignored.

Several LECs contend that the Commission has identified no benefits from adopting the proposed rules that would justify the exorbitant additional administrative burden and costs.[30] As long as the LECs stubbornly insist that the competitive nature of the market and the price cap regime obviate the need for even the current affiliate transaction rules, however, it is not surprising they are incapable of recognizing the benefits that will accrue from their adoption.

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[29] Comments of ICA, p. 6 (emphasis added).

[30] Comments of ALLtel, p. 2 ("The proposed rule changes will impose substantial costs and burdens without comparable public benefits."); Comments of GTE, p. 2 ("The proposed rule changes would dramatically increase regulatory costs and burdens without improving the quality of relevant information made available to the Commission."); and Comments of Cincinnati Bell Telephone Company ("CBT"), p. 1 ("[T]he proposed amendments are unnecessary and would impose an unwarranted burden upon the carriers.)

As MCI noted in its comments, the historical ineffectiveness of carrier audits in detecting carrier abuses (as reported by the General Accounting Office)[31] "supports the Commission's efforts to establish a better means of measuring and monitoring the valuation of transactions between regulated carriers and their nonregulated affiliates in order to place the focus on prevention, rather than detection of carrier transgressions."[32] The Public Utility Commission ("PUC") of Texas recognizes that the proposed rules will achieve "the Commission's goal of ... compensat[ing] for the lack of arm's length dealings between the carrier and its affiliates."[33] Similarly, the Tennessee Public Service Commission ("PSC") Staff supports the rule changes because they will enhance the FCC's "ability to keep carriers from imposing costs of unregulated activities on ratepayers and to keep ratepayers from being harmed by carrier imprudence."[34] The Information Technology Association of America also notes that "[t]he rules proposed by the Notice would significantly enhance the Commission's ability to prevent carriers from imposing the costs of nonregulated activities on ratepayers."[35]

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[31] Telephone Cross-Subsidy, GAO/RCED-93-34, Released February 3, 1993, p. 7.

[32] Comments of MCI, p. 2.

[33] Comments of PUC of Texas, p. 8.

[34] Comments of Tennessee PSC Staff, p. 1.

[35] Comments of Information Technology Association of America, p. 2.

In addition to protecting captive ratepayers from funding nonregulated ventures, the proposed rule changes, contrary to the contention of several commenting parties, are exceedingly pro-competitive.[36] The LECs are concerned that their forays into new markets may be subjected to anti-competitive conditions (e.g., other non-regulated entities would not be subjected to the administrative burdens and costs they assume will accompany the Commission's proposed rules), yet they wish to apply their own "Asymmetric Rule"[37] to ensure that they retain an advantage in entering these new competitive markets. That is, the LECs focus on potential -- yet totally undocumented -- costs to them, but ignore the stifling effect that unfettered cross-subsidization can have on competition in developing markets. As ICA illustrates, the magnitude of BOC operations are such that, even if a single act of cross-subsidization were proportionately small enough to not have an impact on rate levels, the accompanying impact on competition in a developing market might be devastating.[38] Few companies have the financial resources of the regulated LEC operations. The benefits of the proposed rules, therefore, not

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[36] See, e.g., Comments of BellSouth, p. 20; Comments of Ameritech, p. 7; and Comments of Bell Atlantic, p. 1.

[37] GTE has attached the label "Asymmetric Rule" to the Commission's policy whereby LECs must "treat a transaction on either a cost or fair market value basis -- which ever is more unfavorable to the investor." (Comments of GTE, p. 15)

[38] Comments of ICA, p. 8. Even if a single act of cross-subsidization were undetected or immaterial, ICA properly notes that "over time, the cumulative burden of the cross subsidies on regulated services would mount." Id.

only are to ensure that regulated ratepayers do not subsidize non-regulated LEC ventures, but they also are designed to prevent LECs from enjoying anti-competitive benefits by absorbing the costs of competitive ventures in their regulated operations.

More significantly, the LECs have failed to make a factual showing of the "burdensome" administrative costs they argue are associated with the proposed rules. Although USTA attempts to quantify the costs, its estimates are so preposterous that they must be rejected on their face. USTA's estimates that, based on a per affiliate transaction average cost of $40,000 to obtain an estimated fair market value, the cost for all Tier 1 carriers would be $91 million.[39] Apparently, USTA believes it would take the equivalent of an entry-level MBA an entire year to calculate the costs of consulting, accounting, or engineering services for each transaction. MCI submits that a showing more specific than one simply "[b]ased on preliminary market research"[40] should be required for support of such an extreme contention.

V. The Commission Should Adopt its Proposed 75 Percent "Bright Line" Test.

In its comments, MCI supported the Commission's proposed rule whereby 75 percent of a nonregulated affiliate's revenues must be obtained through third party sales in order to qualify for valuation under prevailing

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[39] Comments of USTA, p. 10.

[40] Id.

company pricing standards. By achieving this standard, carriers appropriately assume the burden of demonstrating the validity of the claimed prevailing company prices because it illustrates that the nonregulated affiliate's primary purpose is not to service its regulated affiliates.[41]

The Texas PUC supports the Commission's tentative conclusion that "any nonregulated affiliate that sells less than 75 percent of its output to non-affiliates has too large a volume of affiliate transactions to be deemed to have a predominant purpose of serving non-affiliates."[42] The Tennessee PSC Staff also agrees that it is necessary clearly to differentiate between the valuation of services provided by an affiliate who markets goods or services freely on the open market and one whose primary purpose is to serve the exchange carrier operations:

> [A]n affiliate that has the primary purpose of providing goods or services to the regulated carrier is simply an extension of the regulated carrier and should recover no more in a transaction than the amount that would be expended by the regulated carrier if it performed the operation itself.[43]

The Staff also echoed MCI's view that the test, though most accurately applied on a product specific basis, applying it on a product line basis would achieve adequate accuracy without imposing too great a burden on the LEC.[44]

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41 Comments of MCI, p. 6.

42 Comments of Texas PUC, p. 5.

43 Comments of Tennessee PSC, p. 7.

44 Id., at 9; and Comments of MCI, p. 16.

The commenting LECs oppose the Commission's 75 percent standard, generally arguing that prevailing company price is a reasonable measure of fair market value, regardless of whether the primary purpose of the affiliate is to serve the regulated operations. US West, for example, contends that the "primary purpose of the affiliate does not determine whether the affiliate's prevailing company price is a reasonably reliable measure of fair market value.[45] Similarly, Southwestern Bell characterizes the Commission's effort to make this distinction as a "meaningless exercise,"[46] and proposes instead that "in order to rely on prevailing price, the affiliate must have a substantial number of actual sales to nonaffiliated third parties at that price.[47] The problem is that, unless the number of actual sales to nonaffiliates is truly "substantial," (as established by a standard that can be consistently and objectively applied), the risk is that the affiliate may manipulate its pricing to the third parties in order to achieve certain financial results. Even US West recognizes "that an isolated sale to a single customer could be aberrant," and it alternatively proposes a threshold of three customers in order to "establish that prevailing company prices represent fair market value."[48] The affiliate could easily overstate the "prevailing company price" of items sold to one -- or three -- of its customers,

[45] Comments of US West, p. 17.

[46] Comments of Southwestern Bell, p. 11.

[47] Id.

[48] Comments of US West, p. 19.

when, for example, it bundles those goods or services with other, more competitively priced items.[49] But, having met the three customer limit, the regulated entity could book the acquisition at the price that clearly exceeded fair market value. It is for this reason that the Commission's 75 percent bright line test yields the better result: sales to other entities must be significant by a relative -- yet objective -- standard in order to assure that no pricing manipulations are transpiring.[50]

USTA argues that "the Commission should not attempt to define substantial as a fixed percentage of output [because s]ubstantial cannot be measured by a single test. MCI disagrees. The test must be objective and simple to apply to all situations. Given the myriad of LEC affiliates and product lines, the administrative burden would be entirely too great to establish a subjective or multi-factor test. Nor does US West's "three-customer" test suffice. Selecting a number such as three as a benchmark has no validity as a

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[49] This outcome could result even absent bundling so long as the LEC could find buyers who -- for whatever reason -- were willing to pay too much for certain goods or services.

[50] In its example where an LEC would sell "to forty unaffiliated parties twenty million dollars worth of its sole product," GTE claims that "[t]ransactions of these dimensions would be 'substantial' by any definition that relates to the purpose of the Rule...." (Comments of GTE, at p. 11). Such an example shows the subjectivity associated with any approach besides one based on discrete percentages. Even if such a transaction were deemed "substantial," it raises the question of whether similar sales to only twenty parties would be substantial, or whether sales to forty parties of only ten million dollars would meet the test. The Commission's "bright line" approach to the issue would eliminate the difficulties associated with adopting such subjective -- and easily manipulated -- standards.

standard since it could represent anywhere between .01% and 100% of the entire sales of that product, depending upon the total volume involved. Further, GTE attempts to define "substantial" in an example in which an LEC would sell "to forty unaffiliated parties twenty million dollars worth of its sole product." Though GTE claims that "[t]ransactions of these dimensions would be 'substantial' by any definition that relates to the purpose of the Rule,"[51] such an illustration, instead, shows the subjectivity associated with any approach besides one based on discrete percentages. Even if such a transaction were deemed "substantial," it raises the question of whether similar sales to only twenty parties would be substantial, or whether sales to forty parties of only ten million dollars would meet the test. The Commission's "bright line" approach to the issue would eliminate the difficulties associated with adopting such subjective -- and easily manipulated -- standards.

A percentage-based test is both objective and accounts for disparity between costs and volumes of services or products. Though selection of a certain percentage is, by its nature, arbitrary, there is clear justification for 75 percent. As MCI noted in its comments, anything less than 50 percent is not substantial, while at 100 percent, the test is unnecessary. The equitable alternative, therefore, is to "split the difference," and set the standard at 75 percent as the Commission has proposed.[52]

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[51] Id.

[52] Comments of MCI, p. 6.

VI. The Commission Should Extend Fair Market Valuation to Services.

The LECs are unanimous in their claims that the Commission should not extend fair market valuation to services. Basically they argue that the Commission should not adopt the standard now because the valuation process would be costly or difficult to administer,[53] or because the Commission previously rejected the methodology.[54] Both these arguments should be dismissed simply because the need to ensure proper allocations is both material and increasing, factors that outweigh these LEC objections.

The media is replete with reports of mergers of both companies and technologies in the cable/information/telecommunications arena. The integration of these diverse entities will present regulators with the increasingly complex task of ensuring that goods and services subject to different levels of regulation continue to be separated in a manner that allows for sufficient scrutiny of fully regulated costs and rates. With these major industries set on an inevitable course of collision, the resulting scale of revenues requires the most discerning tests be applied -- regardless of whether they are difficult to monitor, or require additional costs and efforts.

Further, as noted above, the Commission simply must offer a reasonable explanation for its change of policy. Here, the changing industry and the sheer

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[53] Comments of BellSouth, p. 13; Comments of GTE, p. 15; Comments of US West, p. 10; and Comments of USTA, p. 21.

[54] See, e.g., Comments of Pacific Telesis, p. 13; and Comments of Southwestern Bell, p. 14.

volume of revenues at stake justify adoption of a more accurate valuation methodology for services.

VII. The Commission Should Limit the Authorized Rate of Return for Non-Regulated Services and Products Provided to Regulated Operations to the Lowest Point of the Authorized Return Range Allowed for Each Variety of Regulation it Has Adopted.

Commenting parties failed to reach a consensus on the appropriate level at which the Commission should set the authorized rate of return for non-regulated services and products provided to a LEC's regulated operations. Ameritech, for example, believes that "carriers should have the flexibility to use a different rate of return component provided it is reasonable and disclosed in their cost allocation manual."[55] NYNEX encourages the Commission to adopt the current prescribed interstate rate of return -- 11.25 percent -- for all LECs.[56] Bellsouth believes the Commission "should utilize the carrier's earned interstate rate of return for affiliate transactions."[57] Further, the Tennessee PSC Staff argues that "the return component carriers include in affiliate transaction costs should continue to be limited and should be based on a weighted average of the interstate and intrastate returns granted to the regulated carrier,"[58] while the NTCA finds use of a composite rate to be "unworkable."[59]

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[55] Comments of Ameritech, p. 24.

[56] Comments of NYNEX, p. 33.

[57] Comments of BellSouth, p. 31.

[58] Comments of Tennessee PSC Staff, p. 7.

[59] Comments of NTCA, p. 7.

MCI urges the Commission to adopt its proposal that the carriers should set their earnings at the "lowest point of any range that the Commisison allows under its alternative regulatory plans."[60] There is ample justification for such a decision. First, the low end of the range falls within the Commission's "zone of reasonableness."[61] Also, the current ranges were set under "entirely different financial circumstances than exist today, and current economic conditions would not support such a high return."[62] Nor has any carrier submitted any argument that non-regulated goods and services would likely earn at the upper level in a fully competitive market.[63] Nor does a non-regulated entity require the risk component in its return that represents a regulated carrier's need to invest in infrastructure.[64] Finally, for those carriers whose primary purpose is to serve the regulated entities, they can reorganize their corporate structure to "move the product line in question into the regulated entity."[65] For these reasons, MCI urges the Commission to establish the lower end of any authorized range as the rate of return at which nonregulated affiliates should target their earnings.

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[60] Comments of MCI, p. 10.

[61] Id., at p. 11.

[62] Id., at p. 12.

[63] Id.

[64] Id., at p. 13.

[65] Id.